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ROGER L. ANDERSON
Executive Director

November 10, 2004

Keith Rake, Deputy Assistant Commissioner
Office of the Assistant Commissioner
Department of the Treasury
Bureau of the Public Debt
200 3rd Street
Parkersburg, West Virginia 26101

Re: Docket Number BPD-02-04

Dear Mr. Rake:

I am submitting these comments to the proposed changes to the regulations governing State and Local Government Series securities ("SLGS") described in the Notice of Proposed Rulemaking ("NPRM") dated September 24, 2004.

The NPRM describes various types of problems that the proposals are addressing. I believe, however, that the proposals are an overreaction to the problems described and urge Treasury to take a more measured approach to solving those problems. Treasury's overreaction threatens to undermine the attractiveness of SLGS and therefore the strength of the whole SLGS program. The unintended consequences of an overreaction could well be worse than the problems Treasury is seeking to solve.

The NPRM raises three kinds of issues: administrative issues, cash and debt forecasting issues and policy issues.

ADMINISTRATIVE ISSUES:

I agree with the proposal to require use of SLGSafe. SLGSafe improves the accuracy of the SLGS program, and it saves valuable staff time at the Bureau of Public Debt. As a purchaser of SLGS and a user of SLGSafe, I too find it convenient and easy to use.

On another matter, however, I suggest that the Department has not fully evaluated the administrative burden involved with setting SLGS rates each morning. Closing prices for marketable Treasuries, which are currently used for setting SLGS rates, are the easiest benchmarks to use. Using any other prices could easily be more difficult for Treasury to administer.

CASH AND DEBT FORECASTING ISSUES:

Mandating use of SLGSafe will go a long way towards resolving Treasury's cash forecasting issues. All the subscription information will be entered electronically at the Bureau of Public Debt and will also be immediately available in Main Treasury. There will be no delays for data processing.

I do not believe, however, that prohibiting cancellation of SLGS subscriptions will improve cash and debt forecasting. Currently, cancellations must be received by Treasury, depending on the size of the subscription, 5 or 7 days before the issue date. These deadlines are the same as those for filing new subscriptions. Forecasting cash balances and borrowing needs is no easier if a subscription is received 7 days before issue date than it is if a cancellation is received 7 days before issue date. By eliminating the flexibility to cancel subscriptions, the effect will be to delay subscriptions until the deadline. Treasury would therefore have just as little notice of subscriptions under the proposed rules as it currently does for cancellations.

POLICY ISSUES:

I approve of the requirement for a certification, at the time of a SLGS subscription, that the subscription is in connection with a specific issue. This alone will serve to prevent many of the problems that have been described in the press. I suggest, however, that the requirement that the bond issue have been authorized is too restrictive. Many transactions are the result of months of work before the official authorization, which is in many cases the final step. I submit that requiring a certification that a subscription is in connection with a particular issue should serve Treasury's purposes sufficiently.

The bigger policy issue concerns Issuers' ability to eliminate negative arbitrage. The NPRM states that it is inconsistent with the purposes of the SLGS program to allow issuers: (1) to cancel SLGS subscriptions and resubscribe at higher rates and (2) to redeem SLGS and resubscribe at higher rates.

I suggest that the NPRM is evaluating policy too narrowly. The SLGS program was established as an accommodation to issuers of tax-exempt debt ("Issuers") to help Issuers comply with the arbitrage restrictions of the Internal Revenue Code and the regulations under the Code. Tax law provisions, in brief, prevent Issuers from investing proceeds of tax-exempt debt, with certain exceptions, at yields higher than are being paid on that debt. The Congressional policy therefore is to prevent Issuers from profiting from tax exemption.

The SLGS program was designed to enable Issuers to invest in specially tailored Treasuries that allow the Issuers to comply with the investment restrictions in tax law. As compensation for the ability to tailor the Treasuries an Issuer buys, the maximum yield on a maturity of SLGS is slightly lower than that on comparable marketable Treasuries. The difference is currently 5 basis points.

When long-term tax-exempt rates are higher than short and intermediate-term Treasury rates, however, as is currently the case, the maximum rate on SLGS is less than the maximum allowed by tax law to an Issuer, and the Issuer suffers from negative arbitrage.

Because tax law takes away all the investment upside from Issuers, it would be unfair for the SLGS program to impose additional investment restrictions on Issuers and eliminate Issuers' ability to try to recoup some of their investment losses. The SLGS program was not designed to impose investment restrictions, but rather to make it easier for Issuers to comply with those in the tax laws. There is no Congressional policy that Issuers must accept negative arbitrage.

Because of the discount of at least 5 basis points from marketable securities, SLGS are a favorable financing tool for Treasury. There is approximately \$4.3 trillion debt held by the public, and, at October 31, SLGS accounted for greater than \$160 billion, or more than 3½% of the total. At just a 5 basis point difference, that saves the Treasury more than \$80 million each year in interest costs. To the extent that these proposed rules drive market participants away from SLGS, Treasury will have to replace the lost SLGS sales by selling more marketable securities and will lose a commensurate amount of those savings.

Treasury described the changes made to the SLGS program in 1996 as being designed "to make it easier and less costly for state and local governments to refinance and invest proceeds of tax-exempt bonds." Problems with the SLGS program prior to the 1996 changes had caused many Issuers to invest tax-exempt bond proceeds in open market securities, and that had helped lead to the problems known as "yield burning".

By reducing the flexibility of SLGS and by turning SLGS into an additional investment restriction, Treasury would reduce the attractiveness of SLGS for Issuers. This would cause Issuers to turn back to open market Treasuries. That is not a result anyone should desire.

The NPRM's phrasing that objects to the uses of SLGS as a "cost-free option" indicates that Treasury's objection may not be strictly related to the use of SLGS as an option, but to additional concerns that perhaps Treasury is not being paid enough for the option.

The NPRM is wrong, however, in calling the option "cost-free". As mentioned above, there is at least a 5 basis point discount inherent in all SLGS. I submit that the 5 basis point discount compensates Treasury not just for Issuers' ability to customize the denominations, rates and maturities on SLGS, but also for the option to cancel and resubscribe in order to eliminate negative arbitrage. The required use of SLGSafe will reduce the marginal administrative costs of the option to nothing.

Further, there is another 5 basis point discount whenever SLGS are redeemed prior to their maturity. Treasury thus gets paid 5 basis points whenever an Issuer redeems SLGS in order to reduce negative arbitrage. It is an open question whether that amount is sufficient. As the NPRM recognizes, due to the unique circumstances involved in every redemption and resubscription, it would be impossible to determine a pricing formula that is appropriate in every circumstance.

Rather than prohibiting issuers from trying to eliminate negative arbitrage, Treasury should use a free market approach. If Treasury feels it is undercompensated for the option, it has means available to increase its compensation. One possibility would be to reduce the redemption period from 60 to 30 days. Market participants would still be able to restructure escrows, but a restructuring that now uses the full 60 days would instead have to be done over two 30-day periods, and Treasury would receive its 5 basis points twice as often. This structure would allow market participants to pursue those restructurings that are cost-effective, and Treasury would benefit right along with Issuers, the people SLGS were designed to help.

Because the tax laws prevent Issuers from investing in SLGS at yields higher than those on tax-exempt bonds, SLGS provide Treasury with the benefits of borrowing at tax-exempt rates. As a beneficiary of and participant in the tax-exempt bond market, Treasury must be sensitive to the practices and conventions of that market, many of which are different from those in the market for publicly traded Treasury securities.

I submit that the unintended consequences of these proposed regulations would “adversely affect [Issuers] in a material way” and therefore that the proposal does indeed constitute a significant regulatory action within the meaning of Executive Order 12866. These proposed regulations are not consistent with that Order’s principle to “impose the least burden on society, including individuals, businesses of differing sizes, and other entities (including small communities and governmental entities), consistent with obtaining the regulatory objectives.” Further, given the adverse effect on Treasury’s own borrowing costs from the proposed regulations, it is in Treasury’s interest to evaluate and pursue less burdensome changes.

Given the seriousness of the concerns raised by the proposed rules, I urge Treasury to hold public hearings before making any decisions on changing the SLGS program.

Sincerely,

A handwritten signature in black ink, appearing to read "Roger L. Anderson". The signature is fluid and cursive, with the first name "Roger" being the most prominent part.

Roger L. Anderson
Executive Director